INDIANA DEPARTMENT OF REVENUE

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Letter of Findings: 09-0223
Sales and Use Tax
For the Tax Years 2005-2007

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ISSUES

I. Sales and Use Tax-"Surgical Supplies".

Authority: IC § 6-2.5-3-2; IC § 6-2.5-3-4; IC § 6-2.5-5-18; IC § 6-8.1-5-1; <u>45 IAC 2.2-5-28</u>; <u>45 IAC 2.2-5-36</u>.

Taxpayer protests the imposition of use tax on its purchase of "surgical supplies."

II. Sales and Use Tax-"Maintenance Support Services".

Authority: IC § 6-2.5-1-1 et seq.; IC § 6-2.5-1-2; IC § 6-2.5-3-2; IC § 6-2.5-3-4; IC § 6-2.5-4-1; IC § 6-8.1-5-1; 45 IAC 2.2-1-1; 45 IAC 2.2-4-2; Sales Tax Information Bulletin 2 (May 2002); Sales Tax Information Bulletin 2 (December 2006).

Taxpayer protests the imposition of use tax on its purchase of "maintenance support services."

III. Tax Administration-Offset of Assessment.

Authority: IC § 6-8.1-9-1; IC § 6-8.1-9-2.

Taxpayer protests the timing of the application of a refund against the assessment.

IV. Tax Administration-Penalty.

Authority: IC § 6-8.1-10-2.1; <u>45 IAC 15-11-2</u>.

Taxpayer protests the imposition of the ten percent negligence penalty.

STATEMENT OF FACTS

Taxpayer is an Indiana health care provider. After an audit, the Indiana Department of Revenue ("Department") determined that Taxpayer owed use tax and assessed a negligence penalty for the tax years 2005, 2006, and 2007. The Department found that Taxpayer had purchased a variety of supplies without paying Indiana sales tax at the time of purchase or remitting use tax to the Department. Taxpayer protested the imposition of the tax on its "surgical supplies" purchases and the imposition of penalties in general. An administrative hearing was held, and this Letter of Findings results.

I. Sales and Use Tax-"Surgical Supplies".

DISCUSSION

Pursuant to IC § 6-8.1-5-1(c), all tax assessments are presumed accurate, and the taxpayer bears the burden of proving that an assessment is incorrect.

The Department found that Taxpayer had purchased certain "surgical supplies" without paying sales tax at the time of purchase, and assessed used tax on the purchase.

IC § 6-2.5-3-2(a) provides, "An excise tax, known as the use tax, is imposed on the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction, regardless of the location of that transaction or of the retail merchant making that transaction." An exemption from the use tax is granted for transactions where the gross retail tax ("sales tax") was paid at the time of purchase pursuant to IC § 6-2.5-3-4.

Taxpayer asserts that its purchase of surgical "catheters, cannula, guide wires, needles, syringes, electrodes, and blades" are exempt from sales and use tax under the durable medical equipment exemption provided under IC § 6-2.5-5-18. Taxpayer supports its assertion by citing to 45 IAC 2.2-5-28(g), which states, "The sale to the user of medical equipment, supplies, or devices prescribed by one licensed to issue such a prescription are exempt from sales and use tax." Taxpayer maintains that since the "surgical supplies" are used to correct a malfunction of the body and its use is prescribed by one licensed to issue such a prescription, the "surgical supplies" are exempt under 45 IAC 2.2-5-28(g).

However, 45 IAC 2.2-5-28(h) states, "The term 'medical equipment, supplies or devices,' as used in this paragraph, are those items, the use of which is directly required to correct or alleviate injury to malfunction of, or removal of a portion of the purchaser's body." (Emphasis added.) Moreover, the "user," referred to in 45 IAC 2.2-5-28(g) is the patient-purchaser. Thus, unless the "surgical supplies" are sold to a patient under a prescription to correct a malfunction to the patient's body, 45 IAC 2.2-5-28(g) does not apply. Here, the transaction in question, the "surgical supplies" purchased, were not a sale to a "user," but rather sales to a "practitioner." 45 IAC 2.2-5-36(a) states, "The gross retail tax shall apply to the... purchase transactions made by licensed practitioners [to acquire]... surgical instruments, equipment and supplies." Since Taxpayer is a "practitioner" purchasing "surgical supplies," 45 IAC 2.2-5-36(a)(3) applies signifying that the purchases of "surgical supplies" are subject to sales and use tax.

FINDING

Taxpayer's protest is respectfully denied.

II. Sales and Use Tax-"Maintenance Support Services". DISCUSSION

The Department found that Taxpayer had purchased "external servers, software licenses, computer software upgrades, computer software updates, and optional maintenance support services" without paying sales tax at the time of the purchase or remitting use tax to the Department. The Department assessed use tax on the purchase pursuant to IC § 6-2.5-3-2.

Indiana imposes a sales tax on retail transactions and a complementary use tax on tangible personal property that is stored, used, or consumed in the state. IC § 6-2.5-1-1 et seq. IC § 6-2.5-3-2(a) provides that the "use tax, is imposed on the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction, regardless of the location of that transaction or of the retail merchant making that transaction." An exemption from the use tax is granted for transactions where the gross retail tax ("sales tax") was paid at the time of purchase pursuant to IC § 6-2.5-3-4.

A retail transaction is the transfer, in the ordinary course of business, of tangible personal property for consideration. IC § 6-2.5-4-1(b). Except for certain enumerated services, sales of services are generally not retail transactions and are not subject to sales or use tax. However, services that are performed as part of a retail "unitary transaction" are subject to sales and use tax. IC § 6-2.5-1-2(b). A retail "unitary transaction" is one in which items of personal property and services are furnished under a single order or agreement and for which a total combined charge or price is calculated. IC § 6-2.5-1-1(a). A unitary transaction includes all items of property and services for which a total combined selling price is computed irrespective of the fact that the cost of services, which would not otherwise be taxable, is included in the selling price. 45 IAC 2.2-1-1(a).

As a threshold issue, it is the Taxpayer's responsibility to establish that the existing tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made."

While Taxpayer agrees that its purchase of software and servers are subject to tax, Taxpayer asserts that a portion of its "unitary transaction" purchase is not. Taxpayer represents that its payments for optional "software maintenance support" are not a purchase of tangible personal property, but are purchases of "support services" that are not subject to sales and use tax. Thus, Taxpayer maintains that if the "software maintenance" is not "inextricable and indivisible" from the amount for the software and servers, this portion of the "unitary transaction" relating to the "software maintenance support" can be removed from the assessment.

During the hearing, Taxpayer provided an "agreement proposal," invoices, and an unsigned e-mail from the software company. However, Taxpayer did not provide a "maintenance agreement/service contract." While the "agreement proposal" listed the upgrades, updates, and licenses that taxpayer was entitled to receive under an optional maintenance/service agreement, prices were not separately listed for each of these items. The e-mail from the software company states "the total... for the software upgrade was \$203,635 in Upgrade software licenses." Taxpayer suggests that only this \$203,635 of the software maintenance amount is subject to tax. Taxpayer further suggests that based upon this email that the rest of the invoiced amount must represent "support services" that were not subject to sales and use tax. Taxpayer asserts that, even though its purchase invoices contemplate a single charge representing a unitary transaction, this information from the vendor substantiates a lesser amount that is subject to tax for the portion relating to the maintenance.

The Department refers to Sales Tax Information Bulletin 2 (May 2002), which in the examples state that sales and use tax applies to the sale of an optional warranty or maintenance agreement in the software situation if there is a guarantee of the transfer of tangible personal property (updates or upgrades) pursuant to the agreement. It also notes:

If the provisions contained in the warranties or [maintenance] agreements are not in complete compliance with all provisions of Rule 45 IAC 2.2-4-2, this will constitute a transaction of a retail merchant selling at retail. Thus, the service provider must collect sales tax on the unitary price pursuant to IC 6-2.5-2-1.

Accordingly, under this version of Information Bulletin 2 that applies to the tax periods May 2002 to November 2006, if the optional maintenance or warranty agreement guaranteed the transfer of tangible personal property, then the maintenance or warranty agreement is subject to sales and use tax unless the taxpayer can demonstrate that any such transfer of tangible personal property was in compliance with 45 IAC 2.2-4-2.

Thus, the optional maintenance or warranty agreements are subject to sales and use tax unless a taxpayer can demonstrate that either the transfer of tangible personal property was not guaranteed pursuant to the warranty/maintenance agreement or the value of the tangible personal property transferred was an inconsequential portion of the cost of the warranty/maintenance agreement—i.e., less than ten percent of the contract price. See <u>45 IAC 2.2-4-2</u>.

Taxpayer has not shown that the maintenance agreement was in complete compliance with <u>45 IAC 2.2-4-2</u> because no copy of a maintenance agreement was provided, and thus, Taxpayer has not met its burden of proof. Nonetheless, based upon the information that was provided by Taxpayer, Taxpayer was guaranteed to receive property under the optional maintenance agreement and did receive property under the agreement in the amount

of at least \$203,635, which represented a consequential amount of the total purchase price.

Additionally, the Department also refers to Sales Tax Information Bulletin 2 (December 2006), which states: Optional warranties and maintenance agreements that also contain provisions for periodic services where tangible personal property will be supplied as a part of the unitary price fall within the ambit of Rule 45 IAC 2.2-4-2....

. . .

If the provisions contained in the warranties or agreements are not in complete compliance with all provisions of Rule 45 IAC 2.2-4-2, this will constitute a transaction of a retail merchant selling at retail.... In the case of software maintenance agreements or optional warranties, the presumption is that tangible personal property in the form of updates will be transferred. Software maintenance agreements and optional warranties are presumed to be subject to sales and use tax. This presumption can be rebutted if the taxpayer can demonstrate that no updates were actually received.

...

Accordingly, under this version of Information Bulletin 2 that applies to the tax periods after November 2006, software maintenance agreements are subject to sales and use tax unless the taxpayer can demonstrate that no property was received. Based upon the information provided by Taxpayer, Taxpayer presented evidence that it received at least \$203,635 of property under the agreement. Therefore, under both version of Information Bulletin 2 that were in effect for the 2005 to 2007 tax years, Taxpayer's purchase of the optional maintenance agreement is also subject to sales and use tax.

FINDING

Taxpayer's protest is respectfully denied.

III. Tax Administration-Offset of Assessment.

DISCUSSION

Taxpayer protests the timing of the application of its approved refund against its outstanding audit assessment. Taxpayer maintains that because the refund claim was determined outside the audit, additional interest and penalties accrued on its audit assessment.

When the Department receives a claim for refund, the Department does not automatically refund the money. Pursuant to IC § 6-8.1-9-1(b), the Department considers the claim by evaluating the evidence provided with the claim, makes a determination on the claim, and mails a decision to the taxpayer. Once a determination has been made in which the Department finds that a refund is due, the money is offset against existing liabilities, credited to future periods, or refunded as provided in IC § 6-8.1-9-2. The statute contemplates this potential delay and provides the taxpayer's remedy when the Department acts in an untimely manner. In IC § 6-8.1-9-2(c), the Department is given ninety (90) days to credit or pay a refund from the date the refund claim is filed. If the Department fails to do so, the taxpayer's remedy is the payment of interest.

Taxpayer's assessment was determined in an audit report that was issued on December 2, 2008. Taxpayer's refund claim was not filed with the Department until December 19, 2008. After evaluating the refund claim, the Department granted the claim in part on March 13, 2009. During the audit process, Taxpayer questioned the auditor about refund claims being considered during the audit process. During the audit process, the auditor repeatedly informed Taxpayer that in order for the auditor to have the proper amount of time to evaluate a refund claim for the audit period that the Taxpayer would need to sign an extension form. Taxpayer repeatedly refused to sign the extension; therefore, the auditor advised Taxpayer that its refund claim would be evaluated separately from the audit. Taxpayer made a business decision to not sign the extension to allow the auditor enough time to include the evaluation of a refund claim in the audit. This decision resulted in any refund being approved occurring at a date later than the audit assessment was issued. The Department appropriately offset the assessment with the refund at the time the refund was actually determined to be due to Taxpayer, on March 13, 2009, as provided under IC § 6-8.1-9-2.

FINDING

Taxpayer's protest is respectfully denied.

IV. Tax Administration-Penalty.

DISCUSSION

The Department issued proposed assessments and ten percent negligence penalties for the tax years in question. Taxpayer protests the imposition of the penalties. The Department refers to IC § 6-8.1-10-2.1(a)(3), which provides "if a person... incurs, upon examination by the department, a deficiency that is due to negligence... the person is subject to a penalty."

The Department refers to 45 IAC 15-11-2(b), which states:

Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and

circumstances of each taxpayer.

The Department may waive a negligence penalty as provided in 45 IAC 15-11-2(c), as follows:

The department shall waive the negligence penalty imposed under <u>IC 6-8.1-10-1</u> if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section.

Taxpayer has provided sufficient information to establish that its failure to pay the deficiency in this instance was not due to Taxpayer's negligence, but was due to reasonable cause as required by 45 IAC 15-11-2(c). While Taxpayer's current circumstances show that Taxpayer acted with reasonable cause, Taxpayer should be on notice that should these circumstances arise again, penalty waiver may not be warranted.

FINDING

Taxpayer's protest is sustained.

CONCLUSION

Taxpayer's protest to the imposition of tax is denied as discussed in Issues I and II. Taxpayer's protest to the timing of the application of the refund against the assessment is denied as discussed in Issue III. Taxpayer's protest to the imposition of penalty is sustained as discussed in Issue IV.

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